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The Significance of Business Models to Investors

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Abstract

The success and failure of a business hinge on its business model, which combines internal and external factors to create value, deliver value, and capture value for stakeholders. Business models comprise the core logic and operation mechanism of a company that determine its competitiveness and long-term profitability. Investors can evaluate a company's financial performance by analyzing its gross profit, net income, cash flow, and return on equity. Companies with a high transfer cost, a large customer base, high consumption frequency, and strong competition threshold are more likely to succeed in the long run. MIT Sloan Management Review identifies five business models that investors prefer, namely creators, manufacturers, distributors, landlords, and brokers. A successful prototype serves as a template for future businesses, but blindly copying a model will not work, as different business models attract various customers based on their needs.

1 Introduction

Why do some businesses thrive under high competitive pressures and attract a vast number of investors? Investors need a business model to understand a company's competitive edge and gain better insight into its operations. By extensively researching the different types of businesses and how well they performed, I recognized that the stock market consistently values specific business models more highly than others. It mainly consists of four types: creators,

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distributors, landlords, and brokers. Of course, besides putting them into categories, we also have to focus on factors such as a business's ROE (Return on Equity), which is a crucial indicator of how efficiently a company can generate profit. By listing these indicators, we can better understand what companies investors prefer and how they view these data frames.

The purpose of this article is to demonstrate why it is essential to analyze what business model a company runs on. This article aims to give insight to future investors on which companies they should consider when evaluating their stocks. It studies the different types of models and differentiates between the various factors. This article consists of four sections. The first section provides a basic definition of a business model. The second section focuses on how business models are necessary for investors when deciding which companies they should invest in. The third section analyzes how to evaluate a successful business model. The fourth section provides crucial information on the types of models proven to be highly valued by investors.

2 What is a Business Model?

According to management guru Peter Drucker, "a business model is supposed to answer who your customer is, what value you can create/add for the customer and how you can do that at reasonable costs." Indeed, the competition between today's corporations is not the competition between products but between business models. The business model is the critical point related to the life and death of the enterprise, the success or failure of the rise and fall. If an enterprise wants to be successful, it must start by formulating a successful business model. This is true for mature companies, new companies, and even more for companies in the development stage. Business models are the key to winning the business competition and the essence of business.

In spite of its increasing popularity and frequent appearances, the term "business model" has yet to be uniquely defined. However, based on extensive research, a business model essentially combines internal and external elements to enable the enterprise to operate in a manner that maximizes value for all stakeholders. it must achieve its sustainable profit goals by forming a complete, high-efficiency, and unique operating system with core competitiveness, to create value, deliver value, and capture value. [2]

The three core components of a business model are three interlocking closed

loops. All three are indispensable. Without one, a complete business model cannot be formed.
1) Creating value is based on customer needs and providing solutions
2) Delivering value is transferring value through resource allocation and activity arrangement
3) Capturing value entails continuously receiving profits through a particular profit model.
A mature business model will have certain business elements hidden behind it. Anyone in the process of operation must match these elements to ensure the possibility of the success of the entrepreneurial project, thus forming a mechanism.

It is important to consider how a start-up will fund itself and whether the chosen business model will be acceptable to the investors he/she may be able to engage. [4] Having a detailed business model gives investors an insight into the company's workings and its competitive advantage. Cash generation and future expansion are facilitated by a strong business model.

Why do companies such as Apple and Tesla gain so much fame amongst investors? Is it their financial metrics, products and services, high performance, or good timing? Probably all of these. However, there may be other factors at play that contribute to their success. In a research conducted at the MIT Sloan School of Management, Weill and his colleagues identified certain business models as being considered more valuable than others in the stock market. Specifically, over the past few years, investors have shown a preference for business models built on licensing intellectual property (such as Walt Disney's business model) and a certain kind of highly innovative manufacturing (such as Apple's). [4] If only from the point of view of profit, all the operations and management of the company serve the business model. However, if all actions of a company are aimed at making money, or if it can only build a business model from the perspective of money, it shows that such a company lacks the "pursuit of profit", and will inevitably enter the ceiling of the industry and the dead end of profit. It will not have a long-term investment value.

As Warren Buffett says,
"The key to investing is not assessing how much an industry is going to affect society, or how much it will grow, but rather determining the competitive advantage of any given company and, above all, the durability of that advantage."
]Alexander Osterwalder, a Swiss business theorist and consultant, said, "Once

you understand business models you can then start prototyping business models just like you prototype products." A successful prototype can serve as a stepping stone for future businesses to follow. It's like a template for success; however, different business models attract various customers based on their needs, making competition fierce within certain types of industries. Thus, blindly copying a model will not work, but what is important is how well the model will be implemented and integrated into a company.

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3 Evaluating successful business models

Investors should find out how a company makes money when evaluating it as a possible investment, which can be done by inspecting its business model.

Despite its importance, a business model may not be able to reveal all the details of a company's prospects. However, the investor who understands the business model can make better sense of the financial data.

A company's gross profit is a factor that analysts and investors consider when evaluating whether or not a business model is successful. It refers to the difference between total revenue and the cost of goods sold (COGS) for a company. [1] Analyzing a company's gross profit compared with its main competitors or with its industry gives insight into how effective and efficient its business model is. However, relying solely on gross profit can be misleading. It is also vital for analysts to see net income or cash flow. The difference between gross profit and operating expenses indicates the real profit generated by the business. [1]

In business models, pricing and cost are the most critical levers. A company can raise prices and discover inventory at lower costs, with both actions increasing its gross profit. When evaluating a business plan, many analysts prioritize gross profit, the primary indicator of a sound business plan. An out-of-control budget could result from a management failure, which can be corrected. In light of this, many analysts believe that companies with the best business models can run themselves. [1]

But of course, a few additional factors will play an essential role in a business's success. A large customer base, high consumption frequency (dependence, addiction, no replacement), and heightened competition threshold (good competition mindset, brand/scale effect) indicate a well-qualified business. The result of an excellent business model must be high ROE (return on equity) plus good free cash flow. The former is a sufficient condition for the latter but not a necessary condition.

4 Business models investors prefer

MIT Sloan Management Review has an interesting breakdown of business models in the article The Business Models Investors Prefer [4]:
1) Creators that sell ownership of products they have created by transforming or assembling raw materials or components. Ford, 3M, and Intel are examples of this type of company;
2) Manufacturers create their products by utilizing raw materials. Automobile manufacturing is another example of this type of business model, which in-

volves assembling prefabricated components. [6] Dell Computers, for example, assembles its computers from parts made by other companies so it would be considered a manufacturer. It is possible for manufacturers to represent their products directly to their customers, or to outsource sales. [7]
3) Distributors such as Walmart or Amazon's retail business, which sell ownership of products they bought but did not substantially modify, except by transporting, repackaging, or marketing;
4) Landlords, which sell only the right to use assets for a specified period of time; Marriott, Hertz, Accenture, and Citigroup are examples of the landlord model. We included in this category companies that employ licenses or subscriptions to sell limited rights to use their intellectual property (IP) assets — companies such as Microsoft and The New York Times;
5) Brokers, which receive a fee for matching buyers and sellers without ever taking ownership or custody of the product; examples include Charles Schwab, eBay, and realtors.

To sum up, the stability of the business model depends on the demand side, not the supply side. As long as the demand side remains stable and minor fluctuations in consumer needs, then the business model will remain. Besides the types of businesses investors prefer found by MIT Sloan, we can also check and make sure the company's ROE is above 20 percent in recent years. This percentage essentially provides investors with an insight into a business's profitability as it calculates how much one can get as a return. The company would also need an excellent record of free cash flow as it's the money a business has left after paying its operating expenses (OpEx) and capital expenditures (CapEx) [8]. More cash would mean a better indication of how well a company can expand and develop; it also means there is enough money to pay off debts, issue dividends, and buy back shares. Lastly and most importantly, the company needs to have a high transfer cost, meaning a high cost for consumers to switch from their products to other products. For example, nowadays more and more people are using Apple products, many even have multiple Apple iOS devices such as MacBooks, iWatches, and Airpods. Since Apple's consumers are so well accustomed to their products, it is unlikely for them to switch to any other operating systems as it comes with a big cost. This makes the company unique, which is also a great factor when deciding to invest in a company.

5 Conclusion

Although investors may value different business models a decade from now due to changes in technology and consumer needs, the concept of a business model remains a crucial tool for analyzing many important strategic decisions. For example, companies can use the framework to help decide when to dispose of one business unit, when to invest in another one and where to look for potential acquisitions. In making these decisions, the key points help to analyze business, not just in the context of a certain type of industry, but also in the context of companies in very different industries that have similar business models. As a result, investors become aware of the company's past and future prospects in a fair and accurate manner.

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